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Natural Resources and Tax

# The Broad Strokes

## What you need to know about the Flow-Through Share Program

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A flow-through share (FTS) is a tax-based financing incentive unique to the Canadian equity market. This is of particular benefit to companies in the natural resource sector, issued by a corporation to a taxpayer.

In essence, this type of share allows a corporation to renounce the taxpayer of "grass-roots" mineral exploration expenditure and development expenses incurred within a specified time period. In doing so, the benefits from this type of investment are passed on to the shareholder by allowing expenditures to be considered theirs for tax purposes.

With respect to the individual taxpayer who invests in a FTSs, there are also non-refundable provincial tax credits available in certain provinces (British Columbia, Quebec, Ontario, Saskatchewan and Manitoba), as well as federal income tax credits of 15%.

### Which kind of companies are able to issue flow-through shares?

An eligible FTS issuer must be a "principal-business corporation", or PBC. The definition of a PBC 'inter alia' includes a corporation whose principal business is:

- mining or exploring for minerals;
- the processing of mineral ores in order to recover metals or minerals from ores;
- the fabrication of metals;
- the marketing of metals or minerals that have been recovered from mineral ores that include minerals or metals recovered from mineral ores processed by the PBC; or
- a combination thereof.

Note that a PBC can include a holding company, if at least 90 percent of its assets are the shares or debt of one or more PBC's that are related to the holding company.

### What kind of costs qualify as exploration and development?

There are specific types of expenditures that are eligible to qualify for flow-through:

- ***"Grass-roots" expenditures*** - expenses that are incurred for the purpose of determining the existence, location, extent or quality of a Canadian mineral resource, including expenses incurred such as prospecting, carrying out geophysical or geochemical surveys, drilling, trenching, digging test pits and preliminary sampling.

Therefore, a taxpayer to whom these types of expenses are renounced can deduct the full amount renounced from any source of income.

- ***Pre-production expenses -***Expenses that are incurred to bring a new mine into production in reasonable commercial qualities (as a general guideline being approximately 60 percent mill capacity for a 90 day long period), including expenses for clearing, stripping, removing overburden, sinking a mine shaft or constructing an underground entry.

  The nature and type of expenses incurred, as noted here, are mine development expenses after the decision was made to proceed. Therefore, those expenses incurred to determine whether to proceed with the development of the mine would not qualify in this category, but may be considered "grass-roots" expenditures provided that they meet the definition.

  Note that where these expenses are categorized as "exploration" (CEE) the taxpayer may deduct the full amount renounced. Those expenses categorized as "development"—the amount renounced is added to the cumulative Canadian development expense (CCDE) pool, which are deductible on a 30 percent declining balance rate basis.
- ***Post-production expenses*** - Expenses (other than those costs that are included in the capital cost of depreciable property) incurred in the sinking or the excavating of a mine shaft, or a main haulage path for a mine or mineral resource in Canada built, or that has been excavated post mine production. A taxpayer to whom such expenses are renounced will add them to the CCDE pool, and can claim a 30 percent declining balance deduction (per annum) basis.

## What are the general rules for renunciation?

In order to be eligible for the FTS benefits, the expenditures must be incurred within 24 months of the date the flow-through share agreement is entered into. Renunciation must be made by the PBC before March 1 of the first calendar year that begins after the 24 month period is up.

Note that the amount renounced by the PBC must equal the gross proceeds that were received by the investor. Therefore, the costs incurred to raise financing will need to be absorbed by the PBC, as the eligible expenditures incurred must equal the gross proceeds, as raised.

## What is this "Look-Back" Rule I've heard about?

The "look-back" rule allows a PBC to renounce the FTS proceeds to be spent on eligible "grass-roots" exploration expenses before the funding is actually spent, effectively providing the shareholder with their tax benefit early. However, there are some significant pitfalls to be aware of when this rule is applied.

There is a special tax (Part XII.6) that may apply when using the look-back rule however, this cost is deductible for tax purposes. The tax will apply to the exploration costs that are not incurred by the end of February of the second year and are required to satisfy the amount to be renounced.

The Part XII.6 tax essentially compensates CRA for the accelerated tax deduction (by 1 year) available to the FTS investor. This tax is determined in respect of each month in a calendar year (other than January).

It is important to incur all renounced expenditures by the end of the second year or otherwise a penalty of 10% on the unspent amount is applicable. It is likely that the FTS investor will be reassessed by CRA and any tax deduction taken for expenditures that should have been incurred will be denied.

## Qualifying Expenditures for Flow-Through Purposes

A PBC must determine whether the expenditures incurred are eligible for FTS purposes with respect to their renunciation to the investor. CRA will likely audit the expenditures renounced and it is up to the PBC to ensure that they qualify for renunciation purposes. In general, qualifying expenditures include the following:

- Drilling, metallurgical testing, and costs to confirm reserves (included in the National Instrument Rule 43-101 compliance report) should qualify;
- General overhead do not qualify;
- Costs incurred for issuing FTS shares, regulatory, legal and accounting costs do not qualify
- Certain types of feasibility studies may not qualify; and
- Certain types of environmental assessments may not qualify.

## Potential Federal Changes

The Liberal government (per the October 2015 election platform) has alluded to a possible future amendment to reduce fossil fuel subsidies and allow for the use of Canadian Exploration Expenses tax deduction only in the case of successful exploration—therefore, limiting deductions for unsuccessful ones—how this is to be determined and implemented is unclear at this point.

## What you need to know

The flow-through share rules can be very complicated to deal with. Therefore, it is important for companies that are looking to raise funding for their exploration activities via flow-through share financing to understand the rules in order to avoid being penalized. If the expenses incurred by the company do not qualify, then the issuing company is likely subject to significant liabilities, not only to potential CRA penalties and interest charges, but also to your shareholders who will need to be compensated for the loss of tax benefits. This could also impact the company's reputation in the market place, which would have serious ramifications.

For more information on the Flow-Through Share Program or if you would like a copy of the article, please contact Daryl B. Maduke.

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